HM Treasury

Financial Reporting Advisory Board Paper

Financial Instrument Discount Rate update & review

Issue:	Whether the Financial Instruments (FI) discount rate should be updated annually.
Impact on guidance:	Yes, if approved by the FRAB. Guidance will be updated via PES papers.
IAS/IFRS adaptation?	No
Impact on WGA?	Potentially, any discount rate changes will have an impact on WGA in the appropriate years.
IPSAS compliant?	Yes
Interpretation for the public-sector context?	No adaptations or interpretations proposed.
Impact on budgetary regime and Estimates?	Potentially, any rate changes will have an impact on budgetary requirements.
Alignment with National Accounts	N/A
Recommendation:	**The Board agree the proposed policy change to update the financial instruments discount rate on an annual basis from 2022-23 and consider whether a wider review of discount rates is merited, and what the scope, focus and objectives of any such review would be.**
Timing:	Any changes approved would be published in Public Expenditure System (PES) paper – anticipated from December 2022.

DETAIL

Background

1. HM Treasury publishes, via an annual Public Expenditure System (PES) paper to government departments, discount rates to apply to the following items reported in annual reports and accounts :
    - General Provisions
    - Post-employment benefits liabilities
    - Financial Instruments
    - Leases (under IFRS 16)

2. The **general provisions** discount rates are used to discount future cash flows related to provisions recognised in accordance with IAS 37 *Provisions, Contingent Liabilities*

and Contingent Assets.

3. The **post-employment benefit** discount rate, applied in accordance with IAS 19 *Employee Benefits,* is used mainly for the financial reporting of unfunded public service pension schemes and early departure provisions.

4. The **financial instrument** discount rate is used for financial instruments in accordance with the requirements of the Financial Reporting Manual (FReM) and IFRS 9 *Financial Instruments* as adapted or interpreted for the public sector.

5. The **lease** discount rate is used where entities apply the HM Treasury discount rate promulgated in PES papers as their incremental borrowing rate, in accordance with the requirements of the FReM and IFRS 16 Leases.

6. At the June 2021 board meeting (FRAB 144), the Board agreed the policy change to updating general provisions long term and very long-term discount rates on an annual basis from 2021-22. The Board was also asked to note and provide comment on the Treasury's plans to update the financial instrument rate, Board members at the time suggested the financial discount rate should also be updated annually. In response, this paper sets out proposals for the Board's consideration,

The financial instrument discount rate

7. The financial instrument discount rate aims to be a measure of the government's long-term cost of borrowing. The FReM adaptation, originally agreed by FRAB (June 2007 FRAB 87), is to apply the higher of the financial instrument rate and the rate intrinsic to the instrument. It is intended to capture the cost of departmental lending below the government's cost of borrowing. Departments do not shoulder the Exchequer financing costs of their assets, and government debt interest costs are not part of the Supply process (where Parliament authorises government expenditure each year). The rate is representative of the costs of government's financing decisions, and it is represented as a single rate using a historic 10 year average of the yield on the mean maturity of gilt stock. Nominal rates are provided and expressed with reference to RPI, as the most significant category of government loans to which it is applied is student loans, which are currently indexed linked to RPI.

8. After consultation with departments and with the Government's Actuary Department (GAD), HM Treasury conducted a full review of the rate's calculation methodology and updated the financial instrument rate for 2021-22 having presented to the Board in June 2021 (FRAB 144). At present, the rate as applied to flows expressed in current prices is RPI -1.1% (until February 2030) and RPI -0.2% (from February 2030), where the financial instrument is index linked to RPI (to respect the implications of the planned reforms to RPI from 2030). The nominal rate is 1.9%.
These are currently present in the PES paper as the following table:

c) Financial instruments		
Nominal Rate		1.9 %
Real Rate (by reference to RPI)	In excess of RPI until February 2030	(1.1%)
	In excess of RPI from February 2030	(0.2%)

Further detail can be found in the PES 2021 (10) paper here.

9. The financial discount rate had not been updated since 2016 and, given the substantial economic changes occurring over that period, this resulted in a significant step change from 3.7%, the previous nominal rate, to 1.9%. HM Treasury proposes the Board agrees to updating the financial instrument rate on an annual basis, lessening the likely step change caused to the rate in future by decreasing the period between updates (see Annex A for a comparison of spot rates over the last 20 years). Similar to the previous policy in respect of long-term general provisions the financial instrument discount rate was intended to be updated at each multi-year Spending Review (SR), however due to wider economic circumstances there had not been a multiyear SR since 2016. The FI discount rate was updated last year in line with HMT's current policy (SR 2021 was the first multiyear spending review since 2016). Consistent with the policy change for general provisions HM Treasury proposes an annual update cycle to avoid step effects. This will bring it in line with HM Treasury's three other discount rates that are all updated on an annual basis, improving consistency, with feedback from consulted departments also suggesting the move will be broadly welcomed by preparers.

Discount Rates moving forward

10. At the March 2022 board meeting (FRAB 146), the Board questioned HM Treasury proposal to use of the financial instrument discount rate for insurance contracts upon adoption of IFRS 17 Insurance Contracts. This prompted a follow up meeting with a board member and HM Treasury in May 2022 regarding the wider approach to discount rates as set out in the background of this paper.

11. The meeting explored the history of HM Treasury discount rates, the regularity of review by the Board and the timeline of the many discount rate discussions and decisions made by FRAB. The board member questioned the need for a further review of the existing methodology of calculating discount rates.

12. For reference, discount rates and the methodology of calculation have been regularly reviewed by FRAB, details as below (also see Annex B).

13. A consultation and in-depth review conducted on the methodology in calculating general provisions discount rates was considered by FRAB in 2017. The four objectives agreed with the Board were:

    - To review the extant discount rate methodology in consultation with the FRAB, aligned to IFRS as well as the public sector context
    - To calculate a discount rate that is based on an appropriate assessment of risk-free rate, reflecting the time value of money
    - Understand the methodologies for setting discount rates used elsewhere in government and any links to the rates set by HM Treasury to value liabilities e.g. options appraisal or compensation schemes
    - Objective consideration and assessment of all available options, ensuring proposal can be benchmarked against private sector approaches to ensure comparability and credibility

14. FRAB was asked for its views on all outcomes and concluded it agreed with the paper's recommendation, i.e. the provision of nominal rates, and recommended HM Treasury provide guidance to entities around inflationary assumptions for future cash flows that HM Treasury subsequently carried out. The full paper presented to the Board in 2017 (FRAB 131) can be found here.

    The discount rate for leases was considered and agreed by FRAB in November 2020 (FRAB 142) and introduced in the December 2020 PES paper.

15. As discussed above, the discount rate for financial instruments was last considered in June 2021 (FRAB 144) where HM Treasury presented its plans to update the financial instrument discount rate. After consultation with the Government Actuary Department, this rate was updated in December PES paper 2021.

16. The rate applicable to post employment benefit liabilities was last updated after advice from GAD as part of the 2017 review. It has been periodically assessed by GAD since it was modified in 2010 to comply with IAS19.

17. At the suggestion of the board member, the Board may wish to undertake a further review of the discount rate methodology beyond that outlined above and one that quantifies the difference between application of rates in the public sector with application under pure IFRS. Annex B: HMT Discount Rates History gives an overview of discount rate developments and the Board's regular and in-depth involvement with their evolution.

18. If the Board concludes further work is merited, clarification is sought over whether the Board considers a review necessary for all rates as described in paragraph 1 or specific rates, and what the focus and objective of any review would be. The Treasury would likely need to commission Government Actuary Department expert advice, at cost, for any comparison and possible quantification of the financial effect of the difference in the current regime to application of IFRS without adaptation and interpretation (with this counterfactual itself not being straightforward to determine). This commission and subsequent advice from GAD would need to be brought back to FRAB for discussion later in the year but it runs the risk of not being sufficiently complete and agreed to influence the rates published in December.

Questions for the Board: Does the Board recommend another in depth review of the methodology for the determination of discount rates? If so, should the review consider all or specific categories of the following discount rates, what should its focus and objectives be, and what degree of priority should be placed on this work in light of other public sector reporting priorities?

- General Provisions
- Post-employment benefits liabilities
- Financial Instruments
- Leases (under IFRS 16)

19. HM Treasury suggests all discussion regarding IFRS 17 Insurance Contracts remains within the IFRS 17 adoption workstream to ensure all aspects of the new Standard are considered holistically. The issue of the discount rate for IFRS 17 is likely to return to the Board when reviewing the draft IFRS 17 Application Guidance at the next FRAB meeting.

This would likely be delayed if a full review is underway to allow the Board to consider the implications of the wider review.

Recommendation

20. The Board agree the proposed policy change to update the financial instruments discount rate on an annual basis from 2022-23 and consider whether a wider review of discount rates is merited, and what the scope, focus and objectives of any such review would be.

HM Treasury
30th June 2022